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on

Implications of the Debt Held by
Housing Related Government Sponsored Enterprises

Mr. Chairman and Members of the Committee, I am Barbara Miles, Specialist in Financial Institutions in the Congressional Research Service of the Library of Congress. Thank you for inviting me to appear before you to discuss the housing-related government-sponsored enterprises (GSEs)¹ and the implications their activities may pose for the economy and the federal budget.

At the end of the first quarter of this year, the three housing GSEs – Fannie Mae, Freddie Mac, and the Federal Home Loan Bank System – had outstanding debt totaling \$1.47 trillion.² For comparison, publicly held, marketable Treasury debt was about \$2.7 trillion.³ The current and projected declines in the publicly held debt of the U.S. government imply that, at current growth rates of about 20 to 25% per year, GSE debt could surpass Treasury debt outstanding by 2003. When Fannie Mae and Freddie Mac's outstanding guarantees of mortgage-backed securities (MBS), \$1.21 trillion (net of the \$508 billion of MBS the GSEs have repurchased), are added in, the GSE presence in capital markets is very nearly equal to the size of the Treasury market.

Both the absolute size of the GSE debt, and its rapid growth have raised concerns about the risks the GSE's activities pose for the economy and the U.S. Government. In this regard, I will discuss two fundamental questions:

First, what is the federal government's responsibility to and for the housing GSEs?

Second, what are the specific risks that these companies' activities pose?

¹There are five GSEs in our financial system. Two operate in farm credit markets – the Farm Credit System and “Farmer Mac.” A sixth GSE, Sallie Mae, provides student loans and is currently in the process of converting to a fully private company.

² Sources: quarterly statements of Fannie Mae, Freddie Mac and the Office of Finance of the Federal Home Loan Banks.

³ This excludes non-marketable debt which, by definition, does not trade in capital markets and is, therefore, not an indicator of market size.

What are GSEs and Why Do We Have Them?

The answer to the first question is tied up in what GSEs are, why we have them, how they are perceived by investors and why. GSEs are a special class of financial institutions in our economy. They are government in that they serve as instruments of public policy for influencing credit allocation in the economy – in this case into the housing sector or, more accurately, into mortgage finance. Their sponsorship means that they have congressional charters that assign them narrow lending powers, but also grant special exemptions and privileges that lower their costs, in part by implying a guarantee that is formally denied. That they are enterprises means that they operate as private sector institutions for the benefit of their owners.

Public Policy Purpose. The initial government purpose of the three housing GSEs is reasonably clear. The 12 regional Federal Home Loan Banks were chartered in 1934 as a collective GSE in order to provide liquidity to savings and loan associations so that they could continue lending for home mortgages, or at least not be forced by depositor withdrawals to call in mortgage loans already made. There was only very limited private sector ability to take the risks associated with assisting thrifts facing liquidity problems; and nothing, short of the commercial banks' Federal Reserve or the federal government itself, could fill the financing gaps on a scale sufficient to deal with the widespread problems of the 1930s. The Banks were chartered to be owned by the S&Ls themselves, and given a series of benefits that lowered their costs. In turn, the Banks made low-cost loans (called "advances") to the S&Ls on the strength of their mortgage lending, and turned a profit for their member-owners in doing so.

Fannie Mae and Freddie Mac were both started to assist in providing liquidity to lenders by developing a secondary mortgage market. A series of problems – including federal and state laws restricting depository institutions – impeded nationwide flows of mortgage funds and made tapping the resources of general capital markets difficult. As a result, funds did not flow in a normal market response from areas with high savings or from investments with low returns into the regions and mortgages where rates and yield were higher. Fannie Mae, originally a government agency in 1938, but rechartered as a GSE in 1968, and Freddie Mac in 1970, were to help solve these problems by doing what the primary lenders could not do: act as national intermediaries to first, move funds across the country by borrowing where funds were cheap to invest in mortgages where rates were high, and second, develop appropriate securities to tap into non-traditional investment sources. Both actions made mortgages funds more uniformly available.

The charter benefits. The benefits that have been granted to the GSEs are significant and valuable. (See Table, attached.) Some of the benefits directly and explicitly lower the costs of operation of the GSEs below those of any other private-sector company. Exemption from State and local income taxes, for example, was worth about \$490 million to Fannie Mae and Freddie Mac last year.⁴ The SEC registration exemption, according to the U.S. Treasury, was worth another

⁴ This assumes a state tax average of about 8% and cooperation under the state tax compacts. See Zimmerman, Dennis. *Unfunded Mandates and State Taxation of the Income of Fannie Mae*, (continued...)

approximately \$280 million. CBO estimates that, were all five GSEs required to register, the federal budget would gain \$313 million in 2001, and about \$1.5 billion for 2001-2005.

Other benefits accord GSE debt preferential treatment, including the eligibility for unlimited investment by depository institutions – circumventing the normal safety and soundness limits on loans to a single borrower – and the eligibility of their debt and MBS as collateral for public deposits. Still others simply provide links that signal that these companies are more “important” than “normal” corporations as a matter of public policy.

Implied Guarantee. The charter value resides not simply in the sum of the individual preferences but in the nature of the charter itself. Even though there is no explicit government backing, because of the benefits and because of the public policy importance of the GSE mission as demonstrated by their special charters, market participants infer that the federal government would not allow the GSEs to fail such that creditors would lose their money.⁵ This is usually referred to as the “implied guarantee,” and it effectively lowers funding costs for the GSEs below those of other private companies in similar financial condition. A series of studies since 1990 have generally put the funding advantage at about 30 basis points (or 0.3 percentage point) below what is available to triple-A companies and about 40 basis points below double-A companies. While there appears to have been some narrowing of this advantage in the past few months, the advantage is still significant.

The implied guarantee also allows for high leverage on the part of GSEs. That is, less capital is needed to assure investors of safety for any given level of assets. Relatively low financial capital allows a higher rate of return for the company so that there is an incentive toward maintaining minimum levels consistent with investor comfort and low borrowing costs. Capital provides a kind of cushion against losses for investors. But the implied guarantee replaces, to some extent, the normal market discipline that would take into account the actual risks of the business operations of the company.

Market power. By most accounts, the problems that gave rise to creation of the housing GSEs have been corrected.⁶ Correction is generally measured in terms of the degree to which housing finance is integrated with general capital markets. Mortgage rates are effectively uniform across the country, and mortgage markets tap funds in the rest of the capital market with relative ease. Further,

⁴(...continued)

Freddie Mac, and Sallie Mae: Implications for D.C. Finances. CRS Report 95-952 E.

⁵All GSEs are required to inform investors that their securities do not carry full-faith-and-credit guarantees. Yet the statutory equivalence of GSE and federal debt for a variety of purposes reassures investors that the government in some way stands behind the debt. Investors are probably correct in their assessments: when the Farm Credit System was in trouble in the late 1980s, it was rescued so that no investors lost.

⁶Jud, G. Donald. Regional Differences in Mortgage Rates: An Updated Examination. *Journal of Housing Economics*, June 1991. Hendershott, Patrick, and Robert Van Order. Integration of Mortgage and Capital Markets and the Accumulation of Residential Capital. *Regional Science and Urban Economics*, May 1989.

many sources of liquidity are now available to primary mortgage lenders, although they would generally be more expensive than the terms available from the GSEs. The charters continue, however, and now contribute to considerable market power.

Because their costs are lower than for non-favored companies, many private sector observers are particularly concerned that GSEs can reap greater-than-competitive profits, even while undercutting pricing of potential competitors. They need only price their products a little below what fully private companies would have to charge. And GSEs control the value of their charters, because increasing business volume increases the extent of the benefits conferred by the charter, while increasing risk adds to the depth of the gains. In short, the special charters confer benefits on the GSEs that increase in value as a company's business volume and risk increase. This arguably provides incentives not only to dominate the assigned market but also to seek ways to continue to grow even after the market to which the GSEs are constrained by charter is saturated. This, in turn, gives rise to new risks for the government.

The Risks of GSE Operations

The risks that GSE operations pose fall into two separate categories: the normal business risks of the GSEs' operations, and the larger risks to the financial system and the economy.

Normal business risks. Normal risks are those that would be experienced by any intermediary in mortgage markets and include the following.

- ! Interest rate risk: that changes in interest rates will result in a loss of economic value.
- ! Credit risk: that borrowers will default on (not repay) loans or other obligations.
- ! Business risk: that factors beyond a firm's control could result in unanticipated loss of earnings, or capital.
- ! Management risk: losses arising from decisions made (or not made) by managers.

Ordinarily, the private market can be expected to maintain discipline over risk-taking by assessing the riskiness of a company's operations and acting in accordance with what it sees. If leverage were high enough (capital were low enough), for example, to raise concerns about insolvency, creditors would demand prompt payment or attempt to accelerate principal repayment where possible, and new credit would become costly. This market-imposed discipline means that a company has every reason, so long as it is solvent, to control its own risk-taking in order to avoid the costs that would be imposed by creditors. GSEs, like other companies, have an incentive to maintain their shareholder value.

In the case of GSEs, however, the market discipline is weaker because of the implied government-backing. Creditors, so long as they continue to infer that GSE debt is near-equivalent to Treasury debt, will allow greater risk and countenance lower capital. GSEs can borrow at preferential rates in good times, and in bad times. While this is supposed to be a strength, it is also

a problem if matters get out of hand because once capital is lost, the GSE may have reason to take greater risks in the pursuit of rewards large enough to work itself back out of difficulty.

A case of not-well handled interest rate risk did create severe problems for Fannie Mae. The secular rise in interest rates that occurred in the 1970s and the sharp rise in 1979 presented major problems for all mortgage lenders who had basically lent for long-term mortgages at fixed rates while financing at shorter term rates. Fannie Mae was such a lender at that time and its high leverage exacerbated its problems. The spread between interest rates on mortgages and the rates required on new debt turned negative. At the same time, fewer mortgages were being prepaid as home buyers either assumed the mortgages of the sellers, or homeowners simply did not move, both reactions to high interest rates that prolonged the expected life of loans held by Fannie Mae and prolonged their losses. According to a 1986 study by HUD (then the sole regulator for Fannie Mae), the GSE was insolvent on a mark-to-market basis every year from 1978 through 1984. The worst year was 1981 when estimated net worth fell to minus \$11 billion and the corporation actually booked losses. Ultimately, Fannie Mae was allowed to grow its way out of difficulty, although it required regulatory forbearance, some tax adjustments, and declining interest rates to return to health after 1985.

All three housing GSEs have safety and soundness regulators who are specifically charged with examination and testing to keep these risks in check. The Federal Housing Finance Board oversees the Banks. The Office of Federal Housing Enterprise Oversight (OFHEO) oversees Fannie Mae and Freddie Mac for safety and soundness, while HUD has responsibility for mission oversight. Both the FHFB and OFHEO have proposed risk-based capital standards that are intended to test the GSEs for excessive interest rate and credit risk and would require capital holdings accordingly. If the tests work as intended and are timely, it should be possible for regulators to require sufficient capital at all times to avoid a repeat of the 1980s experience. Those tests are not yet in effect.

Repurchase of mortgage backed securities. The repurchase of their own MBS by the GSEs can be thought of as a case of repatriating interest rate risk. When mortgages are securitized and sold, the GSE retains the credit risk on the loans, but sells to investors the interest rate risk. MBS are less profitable than portfolio holdings as a result. Repurchase restores profits along with risk. Fannie Mae and Freddie Mac are the largest holders and purchasers of their own MBS, holding nearly 30% of their own issuances and in some recent periods repurchasing a volume equal to or greater than what they issued.

While it is clear that this increases shareholder value, it is difficult to understand what, if anything, it does for mortgage markets. In order to repurchase the securities, the GSEs must issue new debt. Given that U.S. capital markets are highly integrated, mainstream economic theory holds that there should be no lasting change in yields required by the market on either the debt or the MBS. As a result there should be no benefit to pass through to housing markets.⁷

Larger Risks. The larger risks to the financial system and the economy are systemic risk and systematic risk.

⁷The exception would be if GSE debt and MBS were not good substitutes for one another, i.e., the products were not well integrated in capital markets.

Systemic risk. Systemic risk is the likelihood that a failure of one institution would cause widespread failures of other institutions and result in severe damage to the financial system. In the case of the GSEs, the potential for systemic risk is a direct result of the charter provision that allows depository institutions to hold their debt and MBS without limit. Normally, depositories are restricted to no more than 15% of capital in loans to a single borrower. According to the Treasury, banks held over \$210 billion in GSE debt one year ago, which constituted one-third of bank capital, and over \$355 billion in MBS. These holdings have raised concern among banking regulators. A failure of a GSE could create a domino effect if it resulted in the sudden loss of capital at banks and thrift institutions, and could strain the deposit insurance funds were the situation unanticipated or severe enough.

Systematic risk. Systematic risk is basically that risk that cannot be controlled by diversification. This kind of risk brings to mind the old adage about the dangers of putting all your eggs in one basket: it is generally a very risky thing to do. In the case of the GSEs, there are two sides to the risk: first, portfolio theory holds that diversification makes for better management of risk. But by law, the GSEs can only diversify so far. Ultimately, they build and grow on a single sector of the economy, one that because of their dominance and ability to increase dominance, poses systematic risks for the companies. They cannot diversify away from residential mortgages without a change in mission. Beyond some point, they cannot continue to grow without “breaking out” of their assigned market. One recent study estimates that by 2003, Fannie Mae and Freddie Mac will have to control (retain or guarantee) better than 90% of all outstanding conventional/conforming mortgage loans, and essentially all of new loans originated.⁸

On the other side, if the GSEs take over the housing sector, the government runs systematic risk with respect to the housing sector. So long as the agencies have their benefits fully operating, the sector becomes dependent upon these companies and cannot diversify away from them. If the GSEs are allowed into other sectors, they are better diversified, but the economy is not.

Recall now the data on Treasury and GSE debt. The growth in GSE debt, combined with the projected declines in Treasury debt, has led to consideration of GSE debt as the “risk-free” benchmark for pricing debt in securities markets. Indeed, the GSEs have been positioning themselves to fill such a function by regular issuances of debt in a manner that creates an alternative to the Treasury yield curve. The possibility that the Federal Reserve might use GSE securities for conducting monetary policy has also arisen. But a major economic drawback of using GSE securities – or the securities of any other corporation – is that for the benchmark asset to function properly, it should reflect only risks inherent to the economy overall. GSE securities, on the other hand, include risks specific to their corporations, in this case housing sector risks, which are very different than risks to the overall economy. Yet, because of their inferred safety, the private sector could use them as a benchmark anyway. Thus, the problem arises again that the GSEs may have cause to expand their missions to fill the benchmark role.

⁸Wallison, Peter J. and Bert Ely. *Nationalizing Mortgage Risk: The Growth of Fannie Mae and Freddie Mac*. AEI Studies on Financial Market Deregulation, 2000.

The point behind creating GSEs is to increase efficiency by improving the allocation of credit in the economy. But the risk to the economy from introducing what is effectively a subsidized entity into a new market is that current competition will be displaced and economic inefficiency increased.

That completes my prepared statement, Mr. Chairman. I will be pleased to respond to any questions you may have.